3 1761 07488431 3

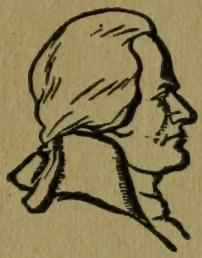
EcC
M6896

EcC
MG896

[Modern business Talks]

FINANCING FUTURE OPERATIONS

Surplus can meet future emergencies only when it is available as well as ample.



MODERN BUSINESS
TALK No. 22
(WITH VOLUME 11)

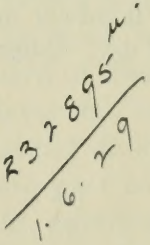
ALEXANDER HAMILTON INSTITUTE
NEW YORK

R.A. 22

F 195

Financing Future Operations

This Talk, to be read in connection with Volume 11, forms part of READING ASSIGNMENT 22



ALEXANDER HAMILTON INSTITUTE
NEW YORK

Copyright, 1919 by Alexander Hamilton Institute
Copyrighted in Great Britain in 1919
All Rights Reserved

READING ASSIGNMENT

The current reading assignment consists of three parts: (1) this Talk, (2) Chapters XI to XIX of the MODERN BUSINESS Text on "Corporation Finance," and (3) Problem 11.

Success in business is largely a matter of knowledge. The best-informed man—other things being equal—is the man who wins the prizes in business life. The sum total of such knowledge is large, but well directed study, faithfully maintained, brings the goal nearer day by day. Diligence and enthusiasm make the task easy.

Financing Future Operations

The fact should be noted that creditors are better protected by capitalizing surplus, thru stock dividends or otherwise, for the reason that dividends may be paid in any amount and at any time out of surplus, but not out of capital.—Page 238, Chapter XIV, Volume 11, of the MODERN BUSINESS Text.

When the directors of the Hesper Mining Company, at the end of its fiscal year, came to consider what disposition should be made of the $250,000 accumulated in excess of its usual dividend requirements, a decided difference of opinion was found to exist. About 75 per cent of the stock was owned by the men who composed the board of directors, and the majority of these were in favor of "cutting the melon" and distributing a substantial dividend.

While all agreed that a certain part of this sum should be set aside for investment, opinions as to the amount to be invested varied widely. One thought that 20 per cent for reserve and 80 per cent for dividends would be a desirable division; another would make the division 40 and 60—the most conservative view being that 60 and 40 would probably be the best division.

"Gentlemen," said the president, "in my judgment no extra dividend should be declared this year. Owing to the exigencies of the mining business, I think we should set aside this entire surplus. I believe it should be instantly available in case an emergency should arise. On such an occasion, we might want a large sum of cash quickly. We can never tell what may happen, or when we may be called upon to face trying situations."

After considerable discussion, in which instances were cited where companies had failed by not being financially prepared, the president's idea prevailed.

Preparing for the Unexpected

Then arose the question of how the surplus should be invested. Various securities were mentioned as affording a desirable opportunity for investment. Railroad bonds, the shares of certain well-known industrials and public service corporations were suggested, most of which would net around 5½ to 6 per cent.

The president surprised everybody present by saying quietly:

"Gentlemen, we can consider only one form of investment in this case, namely, United States bonds."

"What, do you mean to say that we should take a 2 per cent return when we might just as readily get 6?" he was asked by an astonished stockholder.

"It is not a question of profit," the president replied. "We must invest this surplus in such a man-

ner that it may be converted into cash in the shortest possible time. I don't regard it in the light of an investment at all, but merely as a surplus drawing 2 per cent interest. We are engaged in a business in which there is a heavy risk. Many mining companies have failed because, when disaster overtook them, they were unable to obtain ready funds. The form of the investment for this surplus must be such that the bank will loan us on it within an hour, if necessary. The banker would want opportunity to investigate carefully almost any other form of security, and that at a time when every minute we lose might count heavily against us."

The president had his way.

The Unexpected Happens

A few months later the stockholders of the company were shocked by a sudden announcement that the property had been closed down as a result of blasting into an underground watercourse. The flow of water was so great that the cost of pumping it out exceeded the value of the ore.

Within a few hours after receiving this news, the president was able to buy for cash an idle air-drilling plant from which he started a draining-tunnel lower down the mountain-side. Not a single dividend was passed, and the value of the stock in the open market was never lowered. When the company, fourteen months later, emerged from its difficulty, it still had a surplus of $30,000.

Had the $250,000 or any substantial part of it been paid out as proposed at the outset, the company would not have had sufficient funds with which to finance the tunnel and would undoubtedly have gone to the wall. Had the surplus been in a less liquid form, sufficient capital could probably not have been borrowed, for the presence of water in the mine would have made it impossible for disinterested engineers to determine whether a loan of the magnitude required was justified by the property.

The plan of investing surplus in securities that bring a smaller return than if reinvested in the business is not, of course, usually the best financial policy. In the case of the Hesper mine, however, where there were wasting assets and where time was essential, there was ample justification for the course pursued. Generally speaking, it is the better policy to invest the surplus in stock or bonds that will bring returns approaching the corporation's earnings. The author discusses this subject fully in Chapter XIV of our assignment. He does not state what kind of securities should be purchased, but he does explain the advantages of certain forms of stocks and bonds, based upon the experience of successful corporation managers.

Introduction to "High Finance"

When a new enterprise is about to be promoted, knowledge of the fundamental principles of promotion enables one to avoid the pitfalls that await the unwary. It was the lack of this knowledge that made

a Chicago man who had invented a simple kitchen accessory, a target for "financiers" who had "blue sky" in unlimited quantities to exchange for hard cash.

"If I can incorporate a company and raise some money," the inventor thought, "I shall be wealthy in a few years."

Evidently his friends did not share his enthusiasm because he was unable to interest any of them to the extent of putting the necessary money behind his proposition.

Then he read an advertisement that seemed to solve his problem. A Mr. Roberts, whose office was in New York and who, so the advertisement said, had "Wall Street connections," offered to organize corporations and raise money for worthy enterprises.

Our inventor wrote Mr. Roberts, enclosing a photograph of his invention and stating that he thought he needed from $2,000 to $4,000 capital to put it on the market. The reply he received read in part as follows:

It would be much easier and better for you to organize a large company than to organize a small one. I would suggest that a company be incorporated with a capital stock of at least $100,000.

You would receive 51 per cent of the stock in consideration of your turning the patent over to the new company. I would then sell a portion of the balance of the stock to provide the required capital and my rate of commission would be 10 per cent on sales.

I would organize the company for you, furnish all necessary supplies and printed matter—everything complete ready to

begin the sale of stock for $125 in cash. This amount I would expect you to advance to me at the time of placing the proposition in my hands with the understanding that all further expense incurred by me in promoting the sale of this stock is to be paid by me out of my commission.

It will be noticed that Mr. Roberts was under no obligation to actually sell any of this stock and that the $125 "in cash" would have been legally earned by him upon delivery of the certificate of incorporation.

An "Absorbing" Money Market

Our friend was not satisfied. The paltry sum of $125 was evidently too small a one for him to lose. So he answered another advertisement, a little more lurid than the first one. This also held out a helping hand to budding genius. This time, it was a firm of "bankers" in a Southern city who had a "following of investors."

The same data that had been submitted to the man with "Wall Street connections" were submitted to the "bankers," but Mr. Genius was beginning to lean toward the view that "it would be easier to organize a large company than a small one" and inquired of the "bankers" if an issue of $100,000 would be enough. They replied, in part, as follows:

We have carefully gone over the project and have taken into consideration the directors of the corporation and your associates and after considering everything, as conservatively as possible, we have decided to submit to you the following proposition: The money market at the present time is rather easy, and we believe in a condition to absorb such an issue as

you have in the event that the issue is shaped up attractive enough to appeal to our following of investors.

In the marketing of industrial issues we find that the issue does not appeal strong enough to our following of investors unless there is some stronger security back of the project than the corporation itself. You can readily appreciate, Mr. Genius, that the entire success of a corporation rests upon the management of same and those who are connected with the enterprise. To speak plainly, it means that the man behind the gun is the success of the proposition, and in the event that the management was not fully capable of carrying the project out to a successful ending, the investor would, in all probability receive very few dividends, and would more than likely, in time to come, lose his investment.

For this reason, in the event that you would accept our proposition, we would no doubt insist that you close arrangements with some bank or guarantee company to endorse your securities in such a way that even in the event of the failure of the project, the investor would be absolutely secure.

How they had "gone over the project" and "considered everything as conservatively as possible" and how they had "taken into consideration the directors of the corporation and your associates" at a distance of nearly one thousand miles did not appear. The distinction between the directors of the corporation and our inventor's associates might, at another time, have seemed to him unnecessarily fine. Now, however, all he could do was to picture that mysterious thing, the money market, in an easy condition, absorbing his issue. Why, he was actually about to market an industrial issue! There was one point on which he did not see his way clear, however. How could he get an indorsement on his securities that

would make them attractive enough to appeal to his "bankers' " "following of investors"?

A Costly "Guarantee"

Mysteriously enough, the very next day, he received a letter from a company with offices in a northern New York city, whose business was that of guaranteeing to the purchaser of stock that its par value would be paid to him at the end of a certain stipulated number of years. They made a strong point of the fact that they indorsed the stock certificates to this effect. They charged only $500 to indorse certificates of a par value of $1,000, guaranteeing that they would redeem these certificates at their par value at the end of twenty years. For a forty-year indorsement, the charge would be but $252. In other words, what they proposed to our financier was that he go out and sell his stock, or pay some other people to sell it for him. When he had sold a share with a par value of $100, he was to turn $25 over to this company, in return for which they would put an indorsement on the back of the certificate to the effect that if, at the end of forty years, the company were out of business and the stock worthless, they would redeem it, paying its par value of $100.

There was only one thing that worried the inventor now. This guaranteeing company wanted with his application a cash payment of 1 per cent of the entire stock issue, or $1,000. This, they said, was to be payment in full for the use of this wonderful plan

and for the company's services—both to cover a period of two years. This, they pointed out, could not in any sense be deemed an expense, since it was only $1 on a share of $100 par value and was deducted from the fee for indorsement. That is, one remitted only $24 instead of $25 when one wanted a certificate indorsed.

Our inventor was never able to take advantage of this golden opportunity, though urged to do so many times by his "bankers," because he was unable to raise the necessary 1 per cent of the total stock issue. It was just as well for him that he was unable. For, you will notice, no guarantee had been given him that the stock of his company would be sold or even that any determined effort would be made to sell it. He would simply have been out $1,000.

The moral of this story is that there is no secret road to the financing of a proposition.

Presenting an Investment Properly

The value of a simple and conventional financial plan is aptly illustrated by the experience of a small group of manufacturers who recently organized a new company. Close by the site on which they had planned to erect a factory was an abandoned town site of about three thousand building lots which they bought in at a very reasonable figure. They argued that the lots would rise rapidly in value as soon as they had their plant in operation and were employing a number of workmen.

They proposed to raise the $300,000 which the company would require by selling the three thousand lots at $100 a lot, giving with each one a share of $100 par value in the company's stock. They admitted frankly to the people to whom they put this proposition that the lots were not to-day worth anything like $100. But, it was pointed out, they would be worth a great deal more than this when the plant was in operation, and then the purchaser would have a substantial profit on his land and in addition would own stock in the manufacturing company.

Now, this looks like a good proposition, and it probably was. But it did not appeal to investors, hence the owners decided to change the plan. This time they offered to sell one share of the stock for $100 and give one lot as a bonus. Still the money did not come in, so they called in an expert in financial matters.

This man offered the stock for sale as stock, and, after pointing out the probable profits of a manufacturing concern of this kind, he simply called attention to the fact that the town site was one of the assets of the corporation and had been acquired with the idea of furnishing suitable housing facilities for the company's working force, so that it could secure and maintain a skilled labor force. The inevitable increase in the value of the land was pointed to as a further factor in making the investment a desirable one.

This plan brought in the money. The mere act of offering either the stock or the land as a bonus had

suggested at once that one or the other could not be worth very much. The last plan, however, looked like a real business proposition, and the fact that the men of the manufacturing company had foresight enough to think of the housing and living conditions of their workmen was a strong indication that they were far-sighted business men.

Reorganizing on a Profitable Basis

Called upon by stockholders to save a local concern from threatened bankruptcy, Josiah Melden discovered that this involved rescuing a dozen other concerns from dissolution for similar causes. Each of these made automobiles; each specialized on some particular part, such as a superior brake, wind shield, radiator or motor. Melden pointed out that if all the devices and parts were incorporated in a single car it would be a superior product and salesmen would have better talking points.

In making an investigation of the companies he desired to bring together, Melden paid quite as much attention to brains as to machinery, factory equipment and location. He found that most of the companies had been abandoned by promoters after the stock selling period was over.

Creditors were pressing the different companies, but Melden was able temporarily to forestall attachments, pending a reorganization, that in all probability would pay them dollar for dollar.

In presenting the proposition to the bankers acting

as underwriters, Melden pointed out that the reorganized company would possess all the valuable units now held by the various individual organizations. There would, moreover, be a great saving in freight production and marketing, and there would be brought into the Zeolite Company men who were experts in the various departments of business. The best in both men and machinery would be preserved, and the resulting economies would undoubtedly more than pay the dividends contemplated. Valuable men from the individual plants were soon marshaled under one roof, in order that each might get the benefit of the knowledge, experience and ability of the others. Factory units were combined, some of them closed, and others reduced to mere assembling plants. In this way he maintained with half the men in one large company an output equal to that produced by the corporations separately organized.

The combined capital of the companies was $4,500,000.

The amount owing was approximately $2,000,000.

The Zeolite reorganization issued $7,500,000 of new common stock in exchange for the $4,500,000 of stock of the old companies. Melden consolidated the collective indebtedness under a $2,000,000 issue of 5 per cent mortgage bonds. He sold $2,500,000 worth of 7 per cent preferred stock, to provide working capital.

The common and preferred stock, plus the bond issue, totalled $12,000,000, on which amount Melden calculated earnings of 12 per cent. Out of the earn-

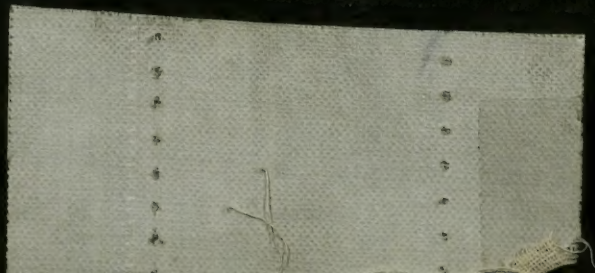
ings, $100,000 would be required for interest on the bonds and $175,000 for dividends on the preferred stock. This would make it possible to pay dividends of at least 15 per cent on the common stock. The benefits of reorganization on a sound financial basis were in this case apparent almost at a glance. As a matter of fact, the first year's earnings were greater than anticipated.

Points that Win

The strange part of this reorganization was that Melden personally knew nothing about the automobile business. He was, however, a keen financier, and a good all-round business man. He surrounded himself with the best talent in the factories which he brought together. The spirit of efficiency banded these men together in the closest cooperation.

The principles which Melden employed, the steps necessary to accomplish similar results and the process of amalgamation are fully and interestingly discussed by the author in Chapters XVI and XIX of the present assignment. The principles involved in effecting consolidations and in financing reorganizations are described in such a way that each one may adopt them to his own particular needs.

NO
26



UTL AT DOWNSVIEW
D RANGE BAY SHLF POS ITEM C
39 11 11 04 13 012 5